Economic Update
HOUSE COMMITTEE ON THE BUDGET
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# Recovery Slows, But Fed Stays on Sidelines

After a rapid expansion out of recession, the pace of the economic recovery has slowed. Recent data show the economic slowdown and recession of 2000-2001 were more pronounced than previously thought, and the subsequent recovery slower than expected. Coupled with the recent stock market declines, key parts of the broader economy appear to have stagnated in July – with little or no improvement in both labor markets and in manufacturing – and consumer confidence and sentiment declined outright. Nevertheless, some forward momentum appears to be continuing in housing and consumer spending, although the consumption gains have been primarily for auto sales in response to incentives. On August 13, the Federal Reserve chose not to lower interest rates, but indicated its awareness of sluggish economic growth and a possibility of action in the near future. In general, the economy is recovering from the slowdown and recession of 2000-2001, but the pace of recovery needs to be stronger to help create jobs, lower unemployment, and generate income gains.

**Blue Chip Economic Outlook, August 2002**

| | 2002.2 | 2002.3 | 2002.4 | 2003 Avg. |
|---|---|---|---|---|
| | | (percent) | | |
| | (History) | | | |
| Real GDP Growth | 1.1 | 2.6 | 3.0 | 3.5 |
| *Change from July:* | -1.5 | -0.7 | -0.7 | -0.1 |
| Unemployment Rate | 5.9 | 6.0 | 6.0 | 5.7 |
| *Change from July:* | 0.0 | +0.1 | +0.2 | +0.2 |
| CPI Inflation | 3.4 | 2.1 | 2.2 | 2.4 |
| 3-month Treasury Bill | 1.7 | 1.7 | 1.7 | 2.5 |
| 10-year Treasury Note | 5.1 | 4.6 | 4.7 | 5.3 |

Note: For 2003, rate of change is for 4th quarter 2002 to 4th quarter 2003; annual average levels for unemployment and interest rates.

### *Recent Data and the Private Consensus Outlook*

*Blue Chip Outlook*: The most recent available data on gross domestic product [GDP] – released by the Commerce Department at the end of July – show that the pace of economic growth in 2000 was slipping faster than previously recognized, and that the recession of 2001 was more severe. In addition, real GDP growth in the second quarter of this year was slower than expected. These data and recent information have led to a reduction in the private consensus Blue Chip growth projections (see accompanying table). Due to slower real GDP growth, the unemployment rate is now expected to rise slightly in the second half of the year, rather than decline as previously expected. As discussed in previous issues of *Economic Update*, because of high trend labor productivity growth, real GDP growth must be above 3 percent to 3½ percent at an annual rate for the unemployment rate to decline.

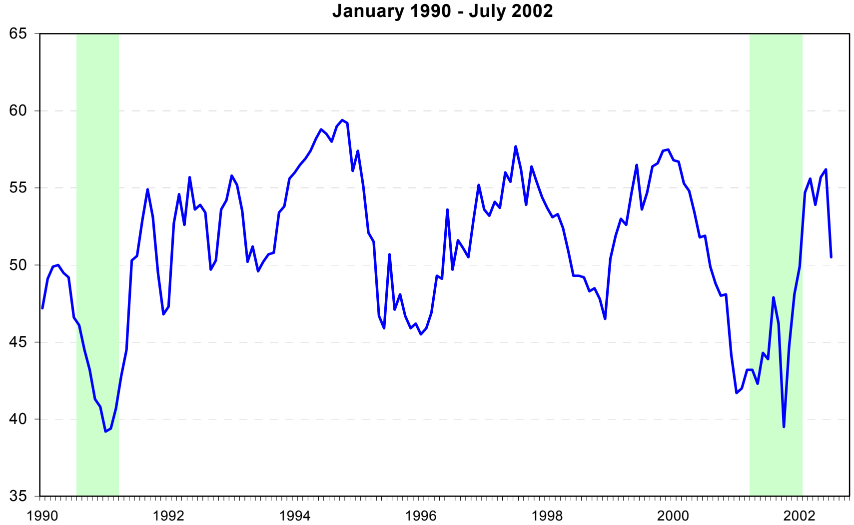
*Recent Data*: New orders for manufacturers' durable goods fell in June, and the Institute for Supply Management [ISM] purchasing manager's index [PMI] – a key measure of manufacturing activity – declined from 56.2 in June to 50.2 in July, indicating that the manufacturing sector was stagnant (see chart on the next page) (a PMI value near 50 indicates that the manufacturing economy is flat, but the general economy is likely expanding moderately). Labor markets in July also reflected the slow recovery: the unemployment rate remained at 5.9 percent, and there was virtually no increase in nonfarm payroll jobs. Consumer sentiment and confidence also fell in July, but remained above the recession lows (see chart on the next page).

Other data, however, are more encouraging. In particular, low interest rates appear to be promoting growth in consumer spending. Retail sales rose 1.2 percent in July, driven by continued strong auto sales – with the surge in auto sales apparently responding to zero-interest financing

(continued on reverse side)

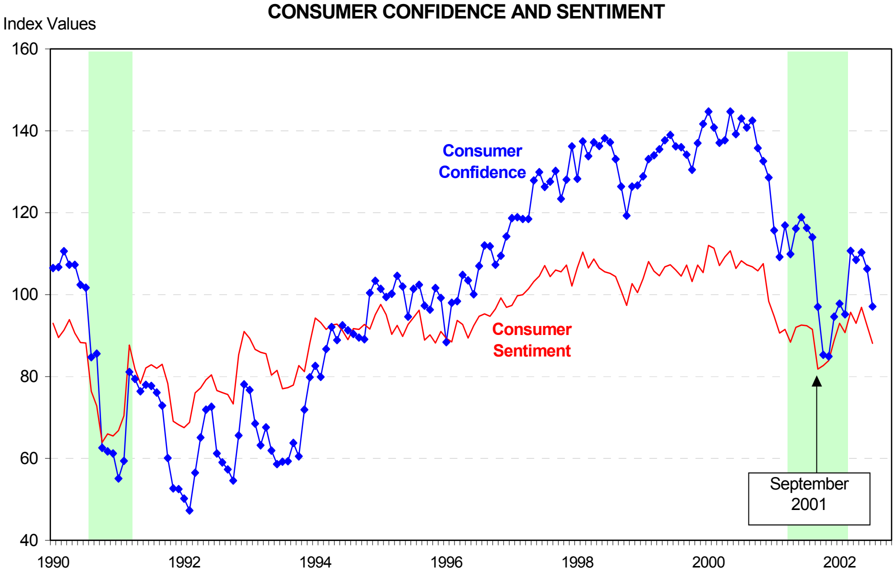
by auto makers. The view is tempered, however, by recognizing that when the increases in autos and gasoline are excluded, retail sales were unchanged from June to July. Mortgage interest rates are down: the rate on 30-year conventional fixed rate mortgages reported by the Federal Home Loan Mortgage Corporation fell to 6.34 percent at the end of July, the lowest on record for the period the rates have been tracked since 1971. Low mortgage rates are promoting residential investment and allowing households to improve their financial positions by refinancing mortgages. Also, weekly unemployment insurance claims fell again at the beginning of August, with the closely watched 4-week average falling to 379,000, the lowest level since January 2001, prior to the recession.

**ISM PURCHASING MANAGERS MANUFACTURING INDEX**
**January 1990 - July 2002**




Shaded areas represent recession periods with an assumed end of the recent recession in February 2002.

**CONSUMER CONFIDENCE AND SENTIMENT**




Shaded areas represent recession periods with an assumed end of the recent recession in February 2002.
Source: Consumer confidence from Conference Board; sentiment from University of Michigan Survey of Consumers.

## *Policy Issues*

The economy has benefitted significantly from last year's tax cuts and rebates, and this year's stimulus legislation with investment tax incentives and extended unemployment benefits. Without those policies, the recession would have been worse, the recovery even slower, and unemployment higher. Policy efforts to promote economic growth and investor confidence have continued, with the passage of fast-track trade promotion authority and corporate accountability. The corporate accountability legislation and regulatory orders by the Security and Exchange Commission [SEC] are aimed at restoring investor and market confidence, in part by requiring chief executive officers and chief financial officers of publicly traded companies to file statements affirming the accuracy of their financial reports.

Although current interest rates are low, the pace of projected economic growth is not fast enough in the short run to immediately reduce unemployment, as noted above. Despite the growing evidence of a slower recovery, the Federal Reserve's Federal Open Market Committee [FOMC], at its August 13 meeting, did not act to cut interest rates.

Still, the FOMC acknowledged its concern about the economy, releasing a statement that said in part: "[T]he Committee recognizes that, for the foreseeable future, against the background of its long run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness." The new statement was a marked shift from that released after the previous meeting at the end of June – which had referred to "balanced" risks for attaining the goals of price stability and economic growth – and signaled possible action in the near future, should the Fed deem it necessary.